REPORT

of

DEPARTMENT OF THE SECRETARY OF STATE
Bureau of Corporations, Elections and Commissions
and
CORPORATE LAW REVISION COMMITTEE
Business Law Section
Maine Bar Association

to the

JUDICIARY COMMITTEE

Summary of L.D. 361
An Act to Adopt the Model Business Corporation Act in Maine

(November 14, 2001)

OVERVIEW

L.D. 361 was submitted to the 120th Maine Legislature, First Regular Session, as a concept draft pursuant to Joint Rule 280. L. D. 361 was carried over to the Second Regular Session of the 120th Maine Legislature.

Since January 2000, the Office of the Department of the Secretary of State and the Corporate Law Revision Committee of the Business Law Section of the Maine Bar Association have engaged in an in-depth study of the Model Business Corporation Act (the "Model Act") and the current Maine Business Corporation Act.

The complete text of proposed L.D. 361 (the "Proposed Act"), with Official Comments and Maine Comments, along with this Report, has been submitted to the Reviser's Office and to the Department of the Secretary of State for display on its website at www.state.me.us/sos.

This Report summarizes the background for and development of the Proposed Act, and the principal changes from current Maine law that the Proposed Act would make, and requests comments from interested parties on the Proposed Act.

CURRENT MAINE LAW

The current Maine corporate law is embodied in the Maine Business Corporation Act, Title 13-A of the Maine Revised Statutes. It was adopted in 1971, based on the then current (1969) version of the Model Act. Since 1971, changes to the Maine Business Corporation Act have been limited and infrequent.

Over the last thirty years, corporate laws in other jurisdictions have evolved substantially, and Maine law has not kept pace. There are limitations and deficiencies in current Maine law that should be addressed. For example:

- Maine law continues the traditional (but arbitrary) concepts of par value, stated capital, capital surplus, etc., which have been largely abandoned in the rest of the country and frequently impair the ability of small, closely-held corporations to redeem or repurchase stock from retiring shareholders and others;

- Under current Maine law, stock cannot be issued for promissory notes or for future services, which impairs the ability to attract capital and key employees;

- Current Maine law permits directors to issue shares, but does not permit them to issue options for stock without shareholder approval, which limits their ability to act to attract and/or retain key employees;

- The duties and liabilities of directors and officers are unclear under current Maine law;

- Current Maine law does not authorize compulsory "share exchanges", a new form of corporate combination available under the Model Act that is available in many other states;

- For dissenting shareholders in fundamental transactions (e.g., mergers), current Maine law is unduly complicated, both with respect to when "appraisal rights" are available and how they are exercised; those provisions are also unfairly slanted against dissenting minority shareholders.

In addition, there are a host of other instances where current Maine law is unnecessarily restrictive compared to the newer corporate laws of most other states.

CHOICE OF THE MODEL ACT AS A MODEL FOR THE STATE OF MAINE

Three principal alternatives were considered as potential approaches for a new Maine corporate law:

(1) Follow the Delaware corporate law: This was rejected because (i) the drafting style of the Delaware law is very general, and interpretive guidance is derived from a massive body of case law from the Delaware courts, which is obviously absent in Maine, (ii) Delaware law is particularly focused on the problems of large publicly held corporations, and (iii) Delaware law has a reputation as being pro-management.

(2) Create an entirely unique Maine law: The alternative of creating a completely new law, borrowing from Delaware law, the Model Act,

existing Maine law, and the laws of various commercially important states (such as New York, California, Pennsylvania and Illinois), was rejected because it would be a massive undertaking, and not necessary.

(3) Adopting the Model Act in Maine: This vehicle was chosen because the Model Act represents the best thinking on corporate law, is continuously updated, has an excellent reputation nationally, and would allow Maine to leverage the enormous work that has already been done developing the Model Act and keeping it current.

THE MODEL ACT

The Model Act was first promulgated over 50 years ago, and has since been continuously updated by a standing committee of corporate law professors and practitioners from around the country.

The Model Act has been adopted in 26 states (and in another 14 states, like Maine, an earlier version of the Model Act is in effect).

The Model Act is a carefully drafted law. It is also accompanied by extensive Official Comments, which explain the rationale behind the provisions of the statute and assist both courts and practitioners in applying the law. In addition, because it is a Model Act that has been adopted in so many other states, the court decisions in those states will provide guidance to practitioners and courts in Maine. Hallmarks of the Model Act include the following:

- *Flexibility* - Substantial flexibility is afforded for shareholders to adopt provisions in the articles of incorporation or bylaws as needed to facilitate raising capital, corporate governance, and relations among shareholders and directors;

- *Addressing the needs of privately held corporations* - Although the Model Act does not generally distinguish between publicly held and privately held corporations, one provision (Section 7.32) is specifically designed for and limited to corporations without publicly traded shares, offering them the maximum ability to establish a customized "private order" to meet the needs of closely held corporations;

- *Modernization* - In the last 30 years, there have been numerous developments in the laws relating to electronic filings, the duties and liabilities of directors, "share exchanges," conversions, just to mention a few, which Maine has not kept pace with and which the Model Act addresses;

- *Predictability* - Maine law leaves open many questions of interpretation, which the Model Act and the Official Comments to the Model Act address, providing greater efficiency and certainty for corporations; and

- *Ongoing updates* – As the Model Act is regularly updated, its use presents the opportunity in Maine for similar regular updates, rather than waiting another thirty years for another wholesale revision.

- *Encourage incorporation in Maine* - A goal was to make the Maine law sufficiently flexible that we could effectively retard the outflow of incorporations that has been taking place from Maine to other states.

The success of the Model Act, evidenced by its adoption in over half the states in this country, is dependent on the wide-spread perception that the standing committee responsible for the Model Act only makes changes that have been carefully considered and tested. On balance, the Department of Secretary of State and the Corporate Law Revision Committee were unanimous in their judgment that the Model Act was the best statutory model for Maine.

DRAFTING PRINCIPLES GUIDING THE PREPARATION OF L.D. 361

The drafting principles guiding development of the text of L.D. 361 were the following:

- Follow the Model Act unless there was a strong reason to vary from it, either due to existing principles of Maine law or otherwise.

- Preserve well-established Maine practices even if they varied from the Model Act (e.g., the common use in Maine of corporations without directors that are instead managed directly by the shareholders).

- Preserve the current balance of corporate governance that applies in takeovers.

HIGHLIGHTS OF THE PRINCIPAL DIFFERENCES BETWEEN THE PROPOSED ACT AND CURRENT MAINE LAW

There follows a summary that highlights the principal differences between the current Maine corporate law and the provisions of the Proposed Act.

Chapter 1: General Provisions

- The Proposed Act eliminates the definitions associated with the historic "legal capital" maze, including "earned surplus," "capital surplus," "stated capital," "surplus," "net assets," and so forth, which under current Maine law frequently impose artificial and unnecessary constraints on Maine corporations, large and small, from engaging in stock redemptions and stock repurchases, dividends, and other transactions, including in transfers of businesses from one generation to another or the sale of a business.

- The Proposed Act simplifies the requirements for filings with the Secretary of State, permitting more officers to sign, and providing for the Secretary of State to establish rules for electronic filings.

- The proposed filing fees will be revenue-neutral.

- The office of Clerk will be continued.

- The Secretary of State will be empowered under the Proposed Act to promulgate forms, which may be mandatory.

Chapter 2: Incorporation

- Under the Proposed Act, the mechanism for incorporation through filing articles of incorporation is unchanged.

- The Proposed Act differs from the Model Act in that it preserves the current streamlined Maine process to form a "directorless" corporation, managed directly by its shareholders.

- Current Maine law (Section 716) broadly exculpates directors "for failure to discharge any duty as a director" unless the director is "found" not to have acted "honestly or in the reasonable belief" that the action was in or not opposed to the best interests of the corporation or its shareholders. The Proposed Act takes a more refined and surgical approach to this topic, in that Section 2.02(b)(4) authorizes the articles of incorporation to limit or eliminate the personal liability of directors except for (a) financial benefit to which they are not entitled; (b) intentional infliction of harm; (c) a violation of Section 8.33 limiting distributions from the corporation to shareholders; or (d) an intentional violation of criminal law. A provision grandfathering Section 716 for existing Maine corporations is included.

Chapter 3: Purposes and Powers

- Chapter 3 of the Proposed Act, broadly stating the powers and the purposes of Maine corporations, carries forward concepts similar to those contained in Chapter 2 of the

Maine Business Corporation Act.

Chapter 4: Name

- The Proposed Act carries forward the current Maine rule that words suggesting "corporateness" are not required in a corporation's name, which is a variation from the Model Act.

- The Proposed Act simplifies review by the Secretary of State of proposed corporate names, establishing more objective standards for review, for conflicts with names of existing organizations, and more clearly delineates the grounds on which the Secretary of State can reject a name.

Chapter 5: Office and Agent

- The Proposed Act would continue the office of clerk, a departure from the Model Act. The position of Clerk is so deeply ingrained in Maine corporate procedures and practice that no useful purpose is served by its elimination.

Chapter 6: Shares and Distributions

- The Proposed Act abandons the terminology of "common" and "preferred" shares, as well as terminology relating to "par value", although the Proposed Act would still permit the Articles of Incorporation to refer to all of those terms.

- The Proposed Act expands upon the types of consideration for which stock may be issued to include (1) cash, (2) promissory notes, (3) services already performed, (4) contracts for services to be performed, or (5) other securities of the corporation.

- With respect to shares issued for future services or for a promissory note, the Proposed Act includes optional provisions to escrow shares until the services are performed, the note is paid, or the benefits are received by the corporation.

- The Proposed Act eliminates the requirement of shareholder approval for certain types of stock options granted to directors, officers or employees.

- The Proposed Act establishes an "opt-in" provision for pre-emptive rights: in the absence of an affirmative opt-in, there are no pre-emptive rights. This contrasts with the elaborate structure of current Maine law, providing different default rules for different events, applied differently to "close corporations" and to other corporations.

- The Proposed Act eliminates the concept of "treasury shares," instead providing that shares of its stock acquired by a corporation simply constitute "authorized but unissued" shares.

- The Proposed Act simplifies when a "distribution" can be made by a corporation. A

distribution generally includes a dividend, a purchase or redemption of stock, or other payment of money or other property to a shareholder in respect of its shares. The Proposed Act adopts a simple test for all "distributions", namely, (1) the corporation's assets must exceed its liabilities (plus any amounts payable to preferred classes of stock), and (2) the corporation must be able to pay its debts as they become due in the usual course (i.e., it must not be insolvent).

- The Proposed Act permits the balance sheet test for distributions to be satisfied on the basis of accounting practices and principles, a fair valuation or other method that is reasonable.

Chapter 7: Shareholders

- The Proposed Act carries forward the concept of a "close corporation" from existing Maine law, a concept which the Model Act does not employ. Chapter 7 (and Chapter 16) of the Proposed Act thus contains a number of non-Model Act provisions that carry forward existing Maine law applicable to close corporations, including the required time period for notices of shareholder meetings, inspection rights, action without a meeting, and the maintenance of shareholder lists.

- The Proposed Act limits the extent to which a corporation can require a high minimum percentage of the shareholders necessary to call a special shareholder meeting, establishing a maximum threshold of 25%, whereas current Maine law has no maximum that the corporation can set.

- The Proposed Act continues the current Maine rule, not followed in the Model Act, that allows holders of bonds and debentures to vote if the articles of incorporation so provide.

- The Proposed Act gives much greater flexibility to privately held corporations through the use of shareholder agreements. Thus, under Section 7.32 of the Proposed Act, shareholders will have greater freedom to "tailor the rules of their enterprise" to their needs, while clarifying that such "private ordering" will be upheld by the courts.

- The Proposed Act adopts the Model Act provisions relating to proxies via "electronic transmissions", a desirable modernization step.

- The Proposed Act adopts the Model Act rule that high quorums or super majority voting requirements can be adopted, but only if they are adopted by the higher quorum or vote that they would add.

- Subchapter D of Chapter 7 contains eight separate sections that now clearly address virtually every important issue in derivative suits. These provisions of the Model Act were already adopted in Maine in 1998 (13-A M.R.S.A. Sections 628-635).

Chapter 8: Directors and Officers

- The Proposed Act (like the Model Act and the corporate statutes of at least 42 other states) contains no requirement for a minimum number of directors. With limited exceptions, current Maine law requires at least three directors, which frequently leads to the appointment of directors to fill necessary slots but who have little or no actual role in the business.

- The Proposed Act preserves the presumption in existing Maine law that a two-thirds vote is necessary to remove a director in mid-term, a deviation from the Model Act.

- The Proposed Act adopts the Model Act provisions dealing with standards of conduct for directors and officers, which are in substance similar to existing Maine law, but with much greater specificity and clarity. In drafting these provisions, the revisers of the Model Act sifted through an enormous volume of case law from around the country, and developed a set of standards that reflected a broad consensus among courts, legislatures and corporate law practitioners. The Proposed Act adopts these Model Act provisions verbatim, as it is important to provide better guidance to directors and officers who face difficult decisions, and to shareholders whose interests are harmed by directors and offices who have been grossly inattentive or who have placed their own interests ahead those of the corporation. The focus of these provisions is on the manner in which directors perform their duties, not the correctness of the decisions made.

- The Proposed Act would continue the provisions of the current Maine law that allowed directors to consider the interests of certain "other constituencies", including employees, communities, vendors, etc.

- As noted above under Chapter 2, the Proposed Act (Section 2.02(b)(4)) sets forth more detailed standards, allowing - but not mandating - the corporation to exculpate directors from liability for monetary damages. As a transitional rule, Section 2.02(d) of the Proposed Act automatically imports an exculpation provision into the articles of incorporation of all pre-existing Maine corporations, which is the fairest way of avoiding changing the rules in midstream for directors who currently rely on the automatic exculpation provisions of Section 716 of the Maine Business Corporation Act.

    - The Proposed Act adopts verbatim the Model Act rules on indemnification of directors and officers by a corporation, which are similar in substance to existing Maine law, but avoid the ambiguities that exist under current Maine law.

- The Proposed Act also adopts verbatim the provisions of the Model Act that detailed procedures for approving transactions in which one or more directors have a serious conflict of interest. These provisions are clearer than existing Maine law and establish "bright line" tests and safe harbors.

- Under the Proposed Act, no specific officers (other than a clerk) are required, a change from Maine law that always requires a president, a treasurer and a clerk.

- The Proposed Act adopts standards of conduct for officers that are similar to those expected of directors, although an officer's ability to rely on others is more limited in some circumstances than is permitted for a director.

Chapter 9: Domestication and Conversion

- Current Maine law (Section 912) authorizes the conversion of a business entity such as a corporation to another type of business entity. The conversion provisions of the Model Act have recently undergone intense study and are expected to be finally added to the Model Act in December, 2001. The Proposed Act includes the provisions of the Model Act (i) enabling corporations to change their state of incorporation, (ii) permitting a domestic business corporation to become a domestic non-profit corporation or a foreign non-profit corporation, (iii) permitting a foreign non-profit corporation to become a domestic business corporation, and (iv) permitting a domestic business corporation to become a domestic or foreign entity that is other than a corporation, as well as permitting a domestic or foreign other entity to become a Maine business corporation. All of these provisions apply only if a Maine business corporation is present either immediately before or immediately after the conversion transaction.

Chapter 10: Amendment of Articles of Incorporation and Bylaws

- The Proposed Act continues existing Maine law limitations on the ability of special Act corporations to amend their articles if inconsistent with the special Act creating them.

- The Proposed Act differs from current Maine law in that it establishes the authority of a corporation to amend its articles of incorporation with a general grant of authority, omitting the "laundry list" of specific permissible types of amendments contained in Maine law.

- The Proposed Act authorizes a number of non-substantive amendments to the articles of incorporation that can be implemented directly by the Board of Directors without a shareholder vote (e.g., to delete the names of the initial directors, etc.).

- The Proposed Act requires amendments to the articles to be first approved by the board of directors in all cases, consistent with the rule that applies to other fundamental transactions (mergers, asset sales, dissolutions), which follows the Model Act but is a variation from existing Maine law.

- For fundamental transactions (mergers, major asset sales, amendments of articles, and dissolutions), current Maine law requires the vote of an "absolute majority" of

outstanding voting shares. The Model Act adopts a rule of the majority of the votes cast, at a meeting at which there exists a quorum consisting of at least a majority of the shares, a lesser standard. The Proposed Act follows a middle path, continuing the present requirement of an "absolute majority," unless the shareholders choose to adopt the lower standard.

- The Proposed Act continues Maine practice, which varies from the Model Act, to the effect that no board vote is required for an amendment if the shareholders by unanimous consent approve the matter.

Chapter 11: Mergers and Share Exchanges

- The Proposed Act continues existing Maine law limitations on the ability of special Act corporations to engage in merger if inconsistent with the special Act creating them.

- As noted above (Chapter 10) the Proposed Act requires a vote by an "absolute majority" unless the articles of incorporation provide a higher quantum of vote, or a lower quantum of vote but not less than a majority of the votes cast, at a meeting at which there exists a quorum consisting of at least a majority of the shares.

- The Proposed Act continues Maine practice, which varies from the Model Act, to the effect that no board vote is required for a merger or a share exchange if the shareholders by unanimous consent approve the matter.

- The Proposed Act continues the concept of existing Maine law (Section 902(5)) that dispenses with a shareholder vote in certain mergers where the surviving corporation issues a limited number of shares. The Proposed Act follows the Model Act, however, and sets that benchmark at 20% of the total number of voting shares or participating shares, versus the 15% threshold in current Maine law. The Proposed Act also extends the same provisions to "share exchanges."

- The Proposed Act removes from the corporate law the restriction that certain types of financial institutions (banking, insurance and trust companies and corporations whose principal business is to derive a profit from the loan or use of money) can only merge with other institutions of the same special class. Provisions so restricting mergers remain in the applicable banking, insurance, etc. laws, and there is no need to retain them in the corporate law, too. Thus, this matter is left to development in the statutes applicable to each special class of corporation, an area of the law which continues to evolve. (For example, national banks can now merge with entities that are not banks, if permitted by state law in the applicable jurisdiction.)

- The Proposed Act preserves the application of existing Maine law Sections 611-A (Certain Business Combinations) and 910 (Control Transactions) to transactions involving an acquisition of a significant interest in publicly-held Maine corporations,

thus leaving in place the current balance of interests in takeovers involving publicly-held corporations. Under the Proposed Act, former Section 611-A is made subject to an opt-out right by vote of the shareholders.

Chapter 12: Disposition of Assets

- The Proposed Act clarifies that certain types of dispositions do not require shareholder approval, i.e., transfers to wholly-owned corporations or entities, and pro rata distributions of assets to the corporation's shareholders, including a spin-off of shares of the subsidiary.

- The Proposed Act, like the Model Act, abandons the historical test that shareholder approval is required if "all or substantially all" of the corporation's assets are disposed of. That rule was vague and difficult to apply. The Model Act approach, adopted verbatim in the Proposed Act, requires a shareholder vote if the disposition would leave the corporation without "a significant continuing business activity," and establishes a safe harbor to the effect that the test is satisfied if the corporation's continuing activities represent at least 25% of its assets or 25% of its income or revenues from continuing operations.

- As noted above (Chapter 10) the Proposed Act requires a vote by an "absolute majority" unless the articles of incorporation provide a higher quantum of vote or a lower quantum of vote, but not less than a majority of the votes cast, at a meeting at which there exists a quorum consisting of at least a majority of the shares.

- The Proposed Act continues Maine practice, which varies from the Model Act, to the effect that no board vote is required for an asset disposition if the shareholders by unanimous consent approve the matter.

Chapter 13: Appraisal Rights

- The Proposed Act adopts the Model Act approach verbatim. The Model Act represents a complete rethinking and revision of the historically difficult area of appraisal rights, in essence: (1) limiting appraisal rights to voting shares, (2) providing that the corporation must, at the beginning of a dissenter's rights proceeding, pay a dissenting shareholder its determination of what "fair value" is, rather than making the dissenter wait for months or even years, (3) if the dissenting shareholder believes a higher "fair value" is appropriate, he must state what that amount is, (4) if the corporation then doesn't commence an appraisal proceeding, it must pay the shareholder's requested "fair value", (5) if either the shareholder's or the corporation's "fair value" is determined to be vexatious or without any basis, the party asserting that value can be assessed with costs and fees, (6) there is a more surgical "market out," where no appraisal remedy is provided for publicly traded stock, and (7) the appraisal rights mechanism is exclusive.

Chapter 14: Dissolution

- If a corporation has not yet commenced business, the incorporators or initial directors may dissolve the corporation without shareholder approval, even after the issuance of shares under the Proposed Act, a variation from existing Maine law.

- As noted above (Chapter 10) the Proposed Act requires a vote by an "absolute majority" unless the articles of incorporation provide a higher quantum of vote, or a lower quantum of vote but not less than a "majority of a quorum", a variation from the absolute two-thirds requirement of current law for dissolutions.

- The Proposed Act eliminates the need for a second filing with the Secretary of State's office to complete a dissolution. Instead, after a corporation files Articles of Dissolution, it continues to exist for a period of three years for the limited purpose of winding up its affairs. Actions pending at the expiration of the three-year period do not abate. The three-year period can be extended by a second filing.

- Certain claims (i.e., contingent claims) are barred under the Proposed Act if an action to enforce them is not commenced within three years after publication of notice.

- The Proposed Act provides a safe harbor for directors who want to be sure they have made "reasonable provision" for liabilities in order to distribute the balance of a corporation's assets to its shareholders. Under the safe harbor, the dissolved corporation may request that a court determine the adequacy and establishes procedures for such a court proceeding.

- The Proposed Act gives the Secretary of State the authority to dissolve, by administrative action, corporations that do not timely file their annual reports, pay their franchise taxes, and so forth. This differs from current law, under which the Secretary of State can generally only "suspend" such corporations. A dissolved corporation may apply for retroactive reinstatement within six years of the effective date of its dissolution, although it loses name protection after three years.

- The Proposed Act contains provisions similar to existing Maine law regarding the grounds for judicial dissolution in an action commenced by a shareholder or a creditor.

- The Proposed Act continues existing provision of Maine law to the effect that in a judicial dissolution action the court has broad equitable powers to fashion a variety of remedies short of actual dissolution. The Proposed Act in this respect did not adopt the Model Act provision that, in certain circumstances, simply provides for a shareholder to be "bought out" by the corporation in lieu of corporate dissolution.

Chapter 15: Foreign Corporations

- The Proposed Act contains provisions similar in substance to the provisions of existing Maine law, addressing when qualification is required, the consequences of transacting business without authority, procedures for obtaining and withdrawing qualification, grounds for revocation of qualification by the Secretary of State, and related matters.

Chapter 16: Records and Reports

- The Proposed Act continues existing Maine practice, permitting corporate records to be kept at the Clerk's office, a deviation from the Model Act.

- The Proposed Act also continues existing Maine law, a deviation from the Model Act, in not requiring close corporations to deliver financial statements within a specified time following the close of a fiscal year.

- Under the Proposed Act a corporation may impose reasonable restrictions in its articles of incorporation or bylaws on the disclosure of financial or other potentially sensitive confidential information about the corporation that is made available to a shareholder demanding the inspection of books and records. The vast majority of Maine corporations are privately held, and financial and other information about such private corporations is not now available to the public.

- The existing Maine practice and rules regarding the filing and content of annual reports is preserved in the Proposed Act, a deviation from the Model Act.

Chapter 17: Transition Provisions

- The Proposed Act is intended to apply to the same group of corporate entities to the same extent that the current Maine corporate law applies.

- Standard provisions regarding savings, severability, repeal and effective date are included in Chapter 17 of the Proposed Act.

- Section 17.01 of the Proposed Act broadly validates corporate action and the provisions of articles and bylaws of Maine corporations that were valid under the law in effect immediately prior to the time the Proposed Act goes into effect.

- The proposed effective date for the new law is January 1, 2003, which should be ample time to transition to enable corporations to adapt to the new law.

REQUEST FOR COMMENTS

Interested parties are encouraged to review L.D. 361 and provide questions or comments to:

Julie Flynn
Deputy Secretary of State
101 State House Station
Augusta, ME 04333-0101
e-mail: Julie.Flynn@state.me.us
207-624-7734
fax: 207-287-5428

or

James B. Zimpritch
Pierce Atwood
One Monument Square
Portland, Maine 04101
e-mail: Jzimpritch@pierceatwood.com
207-791-1270
fax: 207-791-1350